FRBSF Weekly Letter

October 10, 1986

Credit Insurance: Beauty or Beast?

Credit insurance on consumer loans is big business in the United States. In 1985, nearly 70 million credit life insurance policies with coverage of almost $200 billion were insuring individual borrowers against default on car loans, personal loans, and other extensions of consumer credit. Some form of credit insurance covered approximately 70 percent of all closed-end (non-revolving) consumer loans made in 1985.

Given such figures, it is tempting to conclude that credit insurance is well-understood and highly desired by the borrowing public — a view frequently expressed by credit insurance underwriters and the lenders who sell such insurance. Critics of the credit insurance industry, however, have long argued that much of the "popularity" of credit insurance is due to other factors, including borrower ignorance of alternatives to credit insurance and coercive practices by lenders.

Such sharply divergent views have created intense debate over credit insurance. This *Letter* examines some long-standing consumer issues surrounding the credit insurance product. The analysis concludes that credit insurance often can fulfill the legitimate needs of borrowers at a reasonable cost, although premium rates in some states may be excessive. Also, borrowers should carefully assess their need for this product, be aware of potentially abusive sales practices, and recognize their legal rights to refuse the purchase of credit insurance or to seek it from an alternate source.

Purpose of credit insurance

Credit insurance is sold to borrowers in connection with the extension of consumer credit by a lender, usually a financial institution or retailer. It is designed to ensure the repayment of a borrower's debt in the event of death, disability, or loss of property. Lenders typically purchase credit insurance from underwriters on a group basis. The lender holds the policy and issues a certificate of insurance to the borrower. The lender is named beneficiary and directly receives any payments made on submitted claims.

There are three basic types of credit insurance: credit life, credit accident and health (A&H), and credit property insurance. Credit life insurance, which may be bought as single or joint coverage (typically, spouses), is the most commonly purchased type of credit insurance and provides for loan repayment in the event of the borrower's death. It is normally written as declining term insurance in which coverage decreases as the loan is repaid.

A&H insurance is designed to repay a borrower's debt during any period in which a borrower suffers a loss of income due to illness or injury. A&H policies often feature a "retroactive" clause that requires a borrower to be disabled for a specified time period (usually from seven to thirty days) before insurance payments begin. A&H insurance entails greater risk of loss to the underwriter and is more difficult to administer (e.g., more than one claim may be filed).

Credit property insurance is a third type of credit insurance and insures property purchased with the proceeds of a borrower's loan or property used as collateral for a loan. Credit property insurance, like credit life and A&H, is underwritten by several types of firms: specialty companies that engage more or less exclusively in credit insurance, full-line insurance companies, and "captive" insurance companies — those owned by a single lender or group of lenders.

Advantages and disadvantages

In addition to providing debt default protection, credit insurance (particularly credit life insurance) has characteristics that distinguish it from other types of insurance and may provide important advantages to some individuals. Unlike regular life insurance, it is conveniently sold through creditors and can be made available in very small amounts of coverage. The premium rate is constant and does not depend on the size and term of the loan or the insured's health or age (although it is usually not made available to borrowers over 65). Generally, no proof of insurability is required, and credit insurance cannot be cancelled.

Critics of credit insurance, however, argue mainly that its cost is excessive and that its sale has been characterized by abusive practices, particularly coercion.

Excessive cost?
The issue of "excessive" cost remains open to debate. Lenders argue that premium rates for credit insurance reflect the relatively high processing and administrative costs associated with policies of a small average size. They also argue that credit insurance is subject to an "adverse selection" process in which insured persons of disparate ages and health conditions pay identical premium rates — a practice not found in most other types of insurance in which premiums more directly reflect risk. Nevertheless, available evidence suggests that credit insurance rates in some states are higher than needed to cover the sum of claims, reasonable lender compensation, and normal profits to insurance underwriters.

Since states regulate credit insurance rates, much of the controversy has focused on their rate-setting practices. Those who blame states for causing high rates therefore suggest that the solutions, such as competitive rate bidding or the elimination of separate charges for credit insurance, also lie with the states.

Currently, most states establish prima facie maximum rates (quoted in cents per hundred dollars of insurance) at levels designed to generate some targeted "loss ratio" (the ratio of premiums paid to premiums collected). Many states have adopted a target loss ratio of 60 percent, a figure recommended by the National Association of Insurance Commissioners. Maximum rates and actual loss ratios vary widely, however. Some states (e.g., Alabama, Louisiana, and South Carolina) permit creditors to charge up to $1.00 per hundred of credit life insurance. Others set maximum rates at much lower levels: California at $.40; Maine, $.40; New Jersey, $.39; and New York $.28.

These differences are not trivial, especially in view of the small differences in the state-to-state cost of providing credit insurance. In Alabama, the premium for credit life insurance (including interest charges on the financing of the insurance premium) for a $6,000, 48-month loan at a 15 percent annual percentage rate would be approximately $340. In New York, premiums for the same coverage would be about $80.

Since credit insurance is readily obtainable in all states despite widely varying premium rates, maximum rates in many states probably could be lowered without reducing the availability of credit insurance. Although lenders and insurers argue to the contrary, past experiences do not seem to support them. Massachusetts, for example, recently required some creditors to obtain three competitive bids when choosing a credit insurance underwriter. As a result, credit insurance rates charged by lenders affected by this regulation declined about 50 percent from the state maximum of $.50 to approximately $.28 with no observable decrease in insurance availability. A similar experience was recorded in Canada in 1976 when maximum rates were reduced from approximately $.65 to $.35.

Those who believe the cost of credit insurance is excessive point to the sale of credit insurance at the maximum allowable rate in most states. This practice occurs for two reasons. First, lenders are generally prohibited from charging more for credit insurance than they themselves pay. Second, lenders are typically compensated for credit insurance sales through a portion of the collected premiums (up to 60 percent in some states). Thus, lenders as well as insurers profit from charging higher premiums.

A lender's ability to charge borrowers the maximum allowable premium rate may be abetted by the public's unfamiliarity with the alternatives to credit insurance and, to some degree, by the public's insensitivity to the cost when it is combined with monthly loan payments. When priced as a lump sum, the total cost of credit insurance may be apparent. But when financed with a loan (as it usually is), the increase to the monthly loan payment is commonly only a matter of several dollars or less. Thus, many borrowers may be insensitive to the cost of lender-provided credit insurance — particularly in view of what they may perceive to be the high cost of searching for alternative sources of credit insurance.

Abusive sales practices?

Many borrowers voluntarily purchase lender-provided credit insurance as a matter of convenience and out of a desire to minimize search costs. Others, critics argue, are explicitly (and illegally) pressured into buying the lender's credit insurance as a condition for receiving credit. (In certain states it is legal for a creditor to require borrowers to obtain credit insurance. Federal laws, however, prohibit lenders from specifying that it be purchased from a particular source. Moreover, whenever credit insurance is required, the "Truth-in-Lending" Act mandates that its cost be included in the annual percentage rate quoted for the loan.)

The issue of tie-in sales of credit insurance has serious implications given the importance of the function of granting credit in our economy. Seller coercion, however, may be subtle or explicit and is difficult to measure. As a result, its extent has always been a matter of debate.

A 1985 Federal Reserve-sponsored survey provides some support for the view that tie-ins are not perceived by borrowers as an important problem. The survey revealed that 65 percent of consumer loans studied were covered by credit insurance, 90 percent of which was purchased from the lender. Although 20 percent of borrowers who purchased credit insurance said it was either "required" or "strongly recommended," only 4 percent of borrowers felt that their decision to purchase credit insurance made a difference in the lender's decision to grant the loan. In addition, 90 percent of borrowers who purchased credit insurance thought that credit insurance was a "good" idea, and 95 percent were inclined to purchase it again.

Conclusion

This *Letter* has examined certain consumer issues related to credit insurance while leaving the question as to whether borrowers should purchase credit insurance in specific instances unanswered. For many borrowers credit insurance can conveniently fulfill a legitimate need for protection against loan default — and at a reasonable price in many states. For others, it may represent a costly and needless "extra."

Borrowers need to assess their overall financial status when considering the purchase of credit insurance. If a borrower has sufficient regular life insurance or assets with which to repay existing loans in the event of death or disability, credit insurance may be a poor purchase. In addition, credit insurance is less advantageously priced for younger borrowers who can usually add coverage to an existing term life policy at less expense. For older borrowers, or for borrowers who cannot afford or medically qualify for regular life insurance, however, credit insurance may be more worthwhile.

Borrowers should always compare the credit insurance rate being charged with their state's maximum allowable rate. A borrower should also be aware of the benefits and qualifying provisions of his credit insurance policy and of his right to refuse a particular lender's credit insurance in favor of other sources.

A 1985 survey of borrower attitudes toward credit insurance provides evidence that borrowers do not view coercion to buy credit insurance to be an important problem. Efforts on the part of the credit insurance industry and insurance regulators to eliminate past alleged abuses continue to improve the insurance product provided borrowers. Nevertheless, individual borrowers still should carefully assess their own need for credit insurance.

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Editorial comments may be addressed to the editor (Gregory Tong) or to the author.... Free copies of Federal Reserve publications can be obtained from the Public Information Department, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 974-2246.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 9/17/86	Change from 9/10/86	Change from 9/18/85 Dollar	Percent[7]
Loans, Leases and Investments[1] [2]	203,714	2,256	6,782	3.4
Loans and Leases[1] [6]	183,579	1,588	5,865	3.3
Commercial and Industrial	51,008	791	− 106	− 0.2
Real estate	67,437	112	2,798	4.3
Loans to Individuals	39,543	79	1,721	4.5
Leases	5,635	101	231	4.2
U.S. Treasury and Agency Securities[2]	11,921	625	− 86	− 0.7
Other Securities[2]	8,214	43	1,003	13.9
Total Deposits	207,802	802	8,958	4.5
Demand Deposits	52,744	24	5,622	11.9
Demand Deposits Adjusted[3]	36,656	− 196	− 6,383	−14.8
Other Transaction Balances[4]	17,486	− 112	3,528	25.2
Total Non-Transaction Balances[6]	137,573	891	− 190	− 0.1
Money Market Deposit Accounts—Total	47,094	− 63	1,981	4.3
Time Deposits in Amounts of $100,000 or more	34,824	553	− 3,484	− 9.0
Other Liabilities for Borrowed Money[5]	26,619	2,157	2,506	10.3

Two Week Averages of Daily Figures	Period ended 9/8/86	Period ended 8/25/86
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (−)	38	36
Borrowings	51	25
Net free reserves (+)/Net borrowed(−)	− 12	12

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change